RB 2014-02 Guidance on Temporary Mortgage Purchase Programs

July 31, 2014

Background

Some credit unions have become involved in the temporary funding of residential mortgage loans awaiting sale to the secondary market. This may be done through a traditional line of credit to the originating mortgage company or the temporary purchase of the loans from the mortgage company. This Bulletin is only directed toward the latter activity, for which limited quidance is available. Temporary purchase programs generally present greater risk to the credit union than a warehouse line of credit due to the more direct loss exposure and higher volume of activity. This higher volume of activity, when combined with an otherwise minor deficiency or control weakness, can represent a substantial threat to credit union capital if left undetected or uncorrected. Therefore, the board of directors of any credit union operating a temporary purchase program must demonstrate heightened awareness and supervision to avoid undue risks to capital.

Overview of Activity

"Temporary mortgage purchase program" is the name given to activity whereby credit unions purchase single family residential mortgages originated by mortgage companies, while the loans are awaiting resale to investors in the secondary market. An essential element of the program is that the credit union actually takes an ownership position in the loan, thus avoiding aggregation of the individual loans under an

extension of credit to the originator. While temporary purchase programs may be employed in a variety of circumstances, they are most frequently associated with smaller originators who do not qualify for warehouse lines of sufficient size to handle the volume of their activity. In most temporary purchase programs, the credit union's purchase occurs simultaneous with the loan's funding and loan documents are closed in the mortgage company's name. Ownership is assigned to the credit union at closing, as is the purchase commitment from the secondary market investor which has been arranged by the originator.

A loan is normally owned less than 60 days pending the investor's final review. During this period, loan documents may be held by a variety of parties depending on the specific agreement between the credit union and the originating mortgage company. However, a true purchase cannot legally occur unless documents evidencing ownership are within the credit union's possession or control, either directly or through some type of custodial agreement with an independent third party. During the time a loan is owned by the credit union, any payments on the note are likely to be collected by a third party and remitted to the credit union, or held by an agent on the credit union's behalf. The credit union normally receives interest at the face rate on the mortgage loan purchased as well as a flat fee, which varies widely.

When the investor purchases a loan, the credit union recovers the principal, plus interest and fees. Any excess over the purchase price is forwarded to the originator as compensation for their services. If an investor rejects a loan or fails to honor its purchase commitment, the credit union owning the mortgage is responsible for regaining the original loan documents, carrying the loan, correcting any deficiencies, and potentially reselling the asset.

Field of Membership

As prescribed in 7 TAC Section 91.711, credit unions may only purchase a full ownership interest in loans to its members, and, as such, borrowers in a temporary purchase program must meet the field of membership requirements included in the credit union's bylaws and must become members of the credit union before or simultaneous with the actual purchase of the loan. Evidence of the prospective borrower opening a credit union membership account must be retained, along with all other pertinent documentation. As a reminder, credit unions must obtain all necessary information and follow all procedures for opening accounts as required under applicable law, including the Bank Secrecy Act, as amended by the USA PATRIOT Act, its implementing regulations, and any directives that may be issued.

Potential Risks

Due to the success reported by other institutions engaged in temporary mortgage purchase programs, credit unions and their boards may incorrectly believe that there is little risk in the activity. In fact, however, there are numerous incidents of financial institutions sustaining high losses when temporary mortgage purchasing programs are not prudently controlled. Due to the fact that much of the profit is derived from volume, even minor deficiencies may represent a significant threat to credit union capital if left undetected and allowed to compound. Credit unions that attempt to operate temporary purchase programs without sufficient expertise and controls may be cited for unsafe and unsound activity by the Department.

Risk of Fraud

Fraud in a temporary mortgage purchase program presents the largest risk to capital. This is particularly true to the

extent that concentrations exist with any one mortgage originator. While the vast majority of mortgage companies perform their business legitimately, the ease of entry into the mortgage business and the emphasis on volume and quick inventory turnover make the industry susceptible unscrupulous individuals. The weaker the financial condition of the mortgage company and the less effective a credit union's controls, the greater the likelihood of fraud occurring through: (1) multiple sales of the same loan to several parties; (2) alteration or misrepresentation of the credit quality of a borrower; (3) use of fictitious borrowers; or (4) misapplication of funds from the sale or amortization of the loan. Permanent investors do not have to honor commitments on fraudulent credits, and VA and FHA guarantees would not be enforceable. Therefore, any fraud is usually a total loss to the credit union.

Credit Risk

The nature of the temporary purchase program is such that a credit union will have exposure to credit risk in a number of forms. In the ordinary course of the transaction, credit exposure to the mortgage borrower is limited due to the fact that the credit union's period of ownership is confined. However, this exposure increases dramatically when a credit union is forced to repurchase or retain a loan due to early payment default or documentation deficiencies, since the credit union has acquired a longer term exposure in the face of mounting credit and market risk.

A credit union also must evaluate the credit and reputation of the originating mortgage company due to its reliance on that entity to underwrite and document the purchased loans. If a mortgage company is experiencing financial difficulties, cutbacks in personnel and controls may materially affect the quality of the loans being originated, as well as contribute to a failure to meet prescribed due dates. Also, the

possibility of fraud increases in desperate financial situations

Finally, another source of credit risk is that resulting from reliance on the secondary market investor to buy out the credit union's position. Investors under financial stress or experiencing liquidity problems may default on their purchase commitments, particularly if they have failed to hedge their purchase commitments.

Concentrations

The high volume nature of temporary purchase programs often creates asset concentrations many times the level of capital, which amplifies all other risk aspects discussed in this section. Concentrations in loans from one originator, sold to any one investor, or from any geographic region should be closely monitored and controlled. Credit unions also should control the volume of mortgages and outstanding funding commitments from a liquidity and balance sheet management perspective.

Funding

Ideally, credit unions should fund assets with member deposits. However, some credit unions engaged in temporary purchase programs approach a volume and cyclical demand for funding which exceeds their capacity to generate from these deposits. Such credit unions may be tempted to reach out to higher cost and more volatile funding sources, which may adversely impact earnings and liquidity. Also, credit unions which rely on more expensive funds are more likely to compromise prudent standards of underwriting or controls in an effort to compensate for the higher priced funding. To the extent that maturities or repricing intervals are not aligned between the assets and underlying funding, the credit union also may be susceptible to interest rate risk.

Interest Rate Risk

Direct interest rate risk is minimal in a well-run temporary purchase program under which loans are pre-sold to a strong investor, who in turn has hedged their position. Any credit union, however, which purchases loans that have not been pre-sold, is effectively speculating on interest rate movements. This could have a dramatic impact on capital through required mark to market accounting in an adverse environment. Indirect interest rate risk is also evident to the extent that investors are more likely to renege on a commitment in a rising rate environment. Finally, because fee income and the value of servicing rights swing widely based on interest rates, the effect of a changing rate environment on the financial condition of mortgage companies should not be ignored.

Documentation/Market Risk

The structure of most temporary purchase programs is such that the credit union will not have direct control of the loan documents for much of the ownership period. This leaves the credit union highly reliant upon third parties to recognize and protect its ownership rights. Failure to adequately control this aspect of the transaction can subject the credit union to either a complete loss of a negotiable asset through misappropriation, or partial loss of value if only a portion of the original documents can be assembled in the case where the asset must be re-sold.

Documentation risk also arises through poor underwriting, or lost or defective supporting documents. These loans are likely to be rejected by the secondary market investor. In that case, the credit union must either hold the defective loan, or attempt to correct deficiencies and resale it. Generally, a credit union is likely to realize less than the full market price of the loan if forced to sell. In other instances, a

credit union may not be in a position to permanently own any volume of mortgage loans due to the potential strain on its balance sheet and personnel.

Funds Transmittal Risk

Funds are transmitted twice during the typical life cycle of a temporarily purchased loan: from the credit union to the closing agent at the time the loan is originated; and from the investor to the credit union when the loan is purchased. credit union does not sufficiently control these transmittals, it runs the risk of the funds being misappropriated by either the originator or the closing agent. There have been instances when closing agents have colluded with mortgage originators and used loan proceeds in a manner other than represented to the financial institution, or allowed a loan to be sold to multiple purchasers. Also, mortgage originators may have the ability to override a credit union's wiring instructions to an investor, especially if the investor is a government-sponsored agency which provides the originator access to a portion of their data base. Therefore, unless precautions are exercised, the originator could directly receive purchase proceeds from the investor and not notify the credit union of loan sales.

Minimum Standards

The following criteria are outlined to provide a set of standards which should be employed by a credit union in establishing and/or reviewing a temporary purchase program. Due to the nature of risk, strong oversight should be evident for any credit union engaging in a temporary purchase program. Above all, it is essential that the credit union board ensure that adequate and competent staffing has been employed to oversee mortgage purchasing operations. Policies, comprehensive management information systems, quality control programs, and strategic and contingency planning are also

essential to adequately protect capital.

Written Policy

A formal policy with specific limitations and control procedures is important to a well-run program. Components which should be included in such a policy include investment limitations, authorized loan products, maintenance of a list of approved mortgage companies and investors, limits on the purchase of loans which have not been pre-sold, and requirements for periodic reports to the board. Minimum requirements for participating originators, underwriting standards for loans purchased, and controls over the loan funding and sale transactions should also be addressed in a comprehensive policy.

Credit Approval Standards

A credit union should review and approve each loan prior to its purchase. The review should be sufficient to document the credit union's determination that the prospective borrower is eligible for membership, qualifies for the requested mortgage, and that debt service and collateral coverage are sufficient for credit union and investor requirements. Beyond a credit analysis of the borrower and a check of the accuracy of calculations, the documents should be subjected to some limited verification to determine their accuracy and authenticity. This could include a call to the borrower's employer, and contact with the appraiser to verify the estimated value of the property. The extent and scope of verification will depend on the strength of, and the credit union's experience with, a particular originator. A credit review should be performed at least annually on each mortgage company selling to the credit union, along with periodic monitoring through interim reports. In reviewing and approving mortgage companies, consideration should be given site visits by credit union officers; analysis of both to:

audited and interim financial statements; review of credit reports on the company and its owners; verification of fidelity bond and errors and omissions insurance coverage; verification of any necessary state license; review of the "master sales commitment" agreements between the mortgage company and secondary market investors; verification of HUD/FNMA/FHLMC investor status; and review of HUD/FNMA/FHLMC quality control audits if applicable. To the extent that historic performance and rejection information may be available, this would also provide an important insight into a company's capacity to perform.

An analysis of the permanent investors to whom loans are sold is also prudent. Considerations appropriate to this review could include a review of a company's ratings under third party rating services; an analysis of audited annual financial statements; and/or the company's performance under past purchase commitments. The investor's willingness or ability to honor the credit union's bailee letters and comply with prudent sale closing standards (such as responding to verification requests and direct wiring of remittance funds), also should be strongly weighed.

Written Agreements with the Mortgage Company

In order to specifically define the rights and responsibilities between the credit union and selling mortgage companies, a board approved written agreement should be in place for each company selling loans to the credit union. The agreement should address items such as: minimum standards for participating in the program (licensing, bonding, etc.); procedures for handling mortgage loan deficiencies; provisions for acquiring copies of important agreements between the mortgage company and other third parties; procedures for timing and submission of documents to the credit union to facilitate pre-purchase review; and the responsibilities of

each party in regard to mortgage loan defaults.

Mortgage Closing Standards

Most closings under a temporary purchase program are "table funded" by the credit union at an independent title company or title attorney's office. Internal control over the closing process is very important to safeguard the credit union's Steps which should be taken include: direct interests. (telephonic) confirmation with the investor of the purchase commitment; direct or indirect receipt of the original endorsed note and assignment, and certified copies of other documents prior to funding; receipt of an insured closing protection letter verifying fidelity and errors and omissions the closing agent; acknowledged wiring coverage on instructions to the closing agent; and limitation of disbursement at closing to less than the full secondary market price (to avoid pre-paying the originator's and closing agent's fees).

Sale Closing Standards

Credit unions should insist that they receive direct payment of sale proceeds by the investor. To ensure against stale inventory or potential misappropriation of sales proceeds, credit unions also should carefully monitor any loan on the books for over sixty days, and follow up on any sales which do not occur on or before the target purchase date.

Quality Control Program

Credit unions engaging in a temporary purchase program should have a system of quality control which provides a means to identify potential weaknesses and risks in the program. Included in the system would be an independent audit of a portion of loans purchased, the scope and extent of which would vary depending on: the types of loans being purchased;

the credit union's knowledge of the loan originator; and the financial condition and historical performance of the originator. An audit of up to 10-15% of the loans purchased is an industry best practice, with a larger sample employed for a new originator, or one experiencing financial difficulties. The audit should verify that all elements of the transaction complied with the credit union's policies and procedures, as well as re-verify elements of the purchased loan.

Management Information Systems

Comprehensive management information systems are essential to the smooth operation of a temporary purchase program. Credit union management should have detailed and timely reports for supervising daily activity, while the board of directors should receive periodic summary reports on the volume of activity, exceptions, and profitability. It is also important to track: historic data on failed sales; the number and dollar volume of loans rejected by investors; and, documentation/underwriting exceptions by loan production source.

Contingency Planning

Board-approved contingency plans are strongly recommended for programs of any material size to provide a basis for responding to potential interruptions in the program. The "temporary" ownership may become long-term should loans be rejected by investors. Any legal or implied recourse from the investor to the credit union should be considered as well. The credit union's ability to retain some portion of the loans awaiting resale should be evaluated based on a reasonable "worst case" scenario (such as maximum exposure to any one investor). To the extent any actual recourse exists, the credit union should identify funding mechanisms and liquidity sources to buy ineligible loans back from the secondary market

Reserve Standards

The Allowance for Loan and Lease Losses should provide coverage for any risk of <u>credit</u> loss from the mortgages owned by the credit union. In determining how much should be allocated, historic loss experience may be one consideration. Other items which may be assessed include: the risk of investor default; the impact of interest rates on borrowers' repayment capacity on adjustable rate mortgages; and the level of government-sponsored loans. If any loans are sold with recourse to the credit union, separate recourse reserves should be established.

Accounting Standards

The credit union should ensure that accounting techniques comply with generally accepted accounting principles and that activity is correctly reported in regulatory reports. Formal systems should be in place to: document the proposed disposition of each loan at the time of purchase; ensure that loans are recorded as "held for sale" and reported at the lower of cost or market in accordance with Financial Accounting Statement (FAS) 65 (Accounting for Certain Mortgage Banking Activities); and, defer loan fees in excess of cost in accordance with FAS 91 (Accounting for Non-refundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases).

Conclusion

The Department supports credit union involvement in the mortgage lending process. Not only do members benefit from increased credit availability, but credit unions operating with sufficient controls are able to acquire relatively low-risk assets at favorable yields. Temporary mortgage purchase

programs allow credit unions to participate in the mortgage market without having to develop and staff internal origination operations. However, because of the volume of most programs and a substantial element of risk involved, strong board and management oversight is essential.